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Morningstar Digest

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Consolidated Research | Equity-Tesla Inc

Headlines and Tickers Mentioned

Equity Note Published

Tesla Buyout Looks Likely to Us, but Timing and Structure Uncertain

TSLA|USA

Equity Note Published

Tesla Buyout Looks Likely to Us, but Timing and Structure Uncertain– David Whiston, CFA, CPA, CFE

Tesla CEO Elon Musk issued a blog post Aug. 13 that states he is still gauging shareholder interest in Tesla going private at \$420 a share, but our impression of his words is that he thinks it can happen, and we agree. Tesla's board still must receive a formal proposal and then will have to evaluate it, so we think a deal will not happen this week but will eventually be announced. Musk also said the Saudi Arabian sovereign wealth fund has taken almost a 5% stake in Tesla, and he met with it recently about going private. All shareholders would have the choice of having their stock bought out at \$420 a share or remaining invested in a private Tesla. We speculate that retail investors may have their equity moved to a publicly traded special-purpose vehicle while accredited investors would only be able to buy or sell shares every six months.

We are maintaining our fair value estimate. We have changed our thinking since our Aug. 7 note and will not be raising our fair value estimate to the deal price. We normally would increase our valuation to a probability-weighted average of the offered price and our intrinsic value. However, Tesla's possible buyout is abnormal in that equityholders have the option to remain equityholders in a private Tesla, or at least own a special-purpose vehicle that would in turn own private Tesla, so we view this deal as similar to a tender offer. We see Tesla's equity ownership merely transferring to a different vehicle rather than going away as in a traditional buyout, so we do not see a deal changing our opinion of the intrinsic value of Tesla's publicly traded stock.

We think \$420 is way too high a value, given our \$179 fair value estimate. To generate a \$420 per share valuation in our discounted cash flow model, we would need to almost triple our current projection for 2027 midcycle EBIT margin from 9% to nearly 23%. If someone wants to overpay, however, we can't say it's a bad deal for shareholders.

In an Aug. 7 employee email, Musk said he wants to be free of the pressure of quarterly earnings, wild swings in stock prices that hurt all employees since they are shareholders, and attacks by short sellers. He also said going private is the best path forward so Tesla can focus only on growing for the long term, and we agree. Musk expects he will continue to own about 20% of a private Tesla, similar to his present stake. We like this arrangement because unlike normal buyouts, Tesla's deal, if it happens, allows current shareholders to still profit from any appreciation in Tesla's market value over time despite it going private. In the Aug. 7 email, he also said it will probably make sense for Tesla to go public again once its growth is slower and more predictable.

Issues around regulatory approval come to mind because it is unclear how Tesla will allow retail investors who are not accredited investors to own stakes in a private Tesla. That issue is why we think the special-purpose vehicle Musk pointed to in the Aug. 7 email may have to be publicly traded. The investment by investors from the Middle East and China could trigger pushback from the Trump administration on national security grounds, given Tesla's artificial intelligence and autonomous vehicle research, or just from the administration possibly not wanting nations from this part of the world to own a large stake in a U.S. automaker. We also are not clear on the fate of Tesla's existing \$10.9 billion of debt, \$7.7 billion of which is recourse debt. Several billion dollars of Tesla's bonds are redeemable for cash at the holder's option in a change-of-control situation. It is unclear if this buyout would be a change of control, given that equityholders do not have to sell. We think investors financing the buyout will bring new equity capital and possibly retire all of Tesla's existing debt. In addition, while leverage may remain conservative early on, the company could be recapitalized and see significant leverage added back later in the transaction lifecycle, a common practice across the private equity space, according to our PitchBook team that focuses on private market transactions. Musk said in the Aug. 13 blog post on the Tesla website that most of the funding would be equity capital because he does not think it's a good idea to "burden Tesla with significantly increased debt." We agree with that statement as we already are uncomfortable with Tesla's debt levels. Shareholders in public Tesla would be diluted to remain invested with Musk once Tesla is private. Tesla has issued stock almost every year since its June 2010 initial public offering, so we do not think investors will place much concern on new dilution to go private.

Investors in public Tesla considering staying in private Tesla will in our view face the same execution risks Tesla has now--that is, whether it can fund its growth ambitions while also eventually making a high number of vehicles at a profit. If buyout funding takes the form of debt, then we think Tesla will probably continue to have significant balance sheet risk. The difference for the public accredited investor now is that once Tesla is private, daily liquidity will be gone. Our

PitchBook analysts think Musk's liquidity plan makes a lot of sense. They believe the liquidity window to which Musk's plan alluded does not seem different from the standard liquidity that Nasdaq Private Market and other sources have been facilitating for private companies on a regular basis, although not daily. The practice has become more common, and we point to the ability for Lyft, Spotify, and Uber to facilitate private secondary liquidity for shareholders as good examples. We stress, however, that Nasdaq Private Market liquidity for Tesla would be determined by Tesla and would probably be for time windows to buy or sell every six months, based on language in Musk's Aug. 7 email to employees posted on Tesla's website.

Musk in an Aug. 7 tweet said, "Investor support is confirmed. Only reason why this is not certain is that it's contingent on a shareholder vote." We think this statement means Musk believes he has enough votes to go private. Musk also said in the Aug. 13 blog post that he estimates about two thirds of shareholders would go private and therefore not sell at \$420. It sounds to us that he is not done talking to shareholders to gauge interest, but his estimate of about 66% of shareholders not tendering is not far off from our own assumption of 60%. We expect a deal, if announced, would be approved, and we estimate about 40% of shareholders will sell their shares at \$420 or whatever a deal price ends up being, mostly due to their own mandates on not being able to hold private stock or caps on illiquid securities. This assumption puts the shareholder buyout price at \$28.7 billion, by our calculation. We think most shareholders believe in Musk and want to remain invested with him. The six largest shareholders (Musk, Fidelity, Baillie Gifford, T. Rowe Price, TenCent, and the Saudi Arabia sovereign wealth fund) own about 53% of the stock by our estimates. We'd expect all these owners to not sell any of their stock because we think they believe Tesla can be far bigger than it is today. We do expect some forced selling from entities that cannot own private companies, such as index funds or some exchange-traded funds, but we think most Tesla retail and institutional shareholders are very loyal and patient with Musk and will want to remain invested. We think if the deal fails to happen, it would be due to regulatory issues mentioned earlier rather than lack of available capital. Musk said the Saudi sovereign wealth fund has been meeting with him since early 2017, trying to get him to take Tesla private, and at a July 31 meeting this year expressed regret to Musk that he has not taken it up on its offer. We assume the Saudis would put up sizable capital to help fund the deal and that is why Musk's first Aug. 7 tweet on a buyout said, "funding secured."

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